

DIRECT TESTIMONY
OF
JANIS FREETLY
SENIOR FINANCIAL ANALYST

FINANCE DEPARTMENT
FINANCIAL ANALYSIS DIVISION
ILLINOIS COMMERCE COMMISSION

VERIZON NORTH INC. and VERIZON SOUTH INC.

JOINT PETITION FOR AUTHORITY TO ENTER
INTO A FINANCIAL SERVICES AGREEMENT

DOCKET NO. 02-0396

SEPTEMBER 3, 2002

1 **Q. Please state your name and business address.**

2 A. My name is Janis Freetly. My business address is 527 East Capitol Avenue,
3 Springfield, Illinois 62701.

4 **Q. What is your current position with the Illinois Commerce Commission**
5 **(“Commission”)?**

6 A. I am currently employed as a Senior Financial Analyst in the Finance Department of
7 the Financial Analysis Division.

8 **Q. Please describe your qualifications and background.**

9 A. In May of 1995, I earned a Bachelor of Business degree in Marketing from Western
10 Illinois University. I received a Master of Business Administration degree, with a
11 concentration in Finance, from Western Illinois University in May of 1998. I have
12 been employed by the Commission since September of 1998.

13 **Q. What is the purpose of your testimony in this proceeding?**

14 A. The purpose of my testimony is to present my evaluation of the proposed Financial
15 Services Agreement (“FSA”) between Verizon North, Inc. (“Verizon North”) and
16 Verizon South, Inc. (“Verizon South”, Verizon North and Verizon South are
17 collectively referred to as the “Companies” or “Petitioners”) and Verizon Network
18 Funding Corp. (“VNFC”) filed in this proceeding.¹ I recommend additional
19 provisions be incorporated in the FSA to safeguard the Companies’ access to

¹ Although the Petitioners’ proposed FSA has been drafted specifically to Verizon North, my concerns and recommendations with the proposed FSA apply to transactions with both Verizon North and Verizon South.

short-term capital at reasonable cost. In addition, I recommend that the Commission order a reporting requirement for monitoring borrowing and lending transactions under the agreement.

Q. What are the Petitioners' seeking in this proceeding?

A. The Petitioners' are seeking joint authority to enter into a Financial Services Agreement with VNFC, in accordance with 220 ILCS 5/7-101 and 220 ILCS 5/7-102 of the Public Utilities Act.

Q. Please describe the services that VNFC will provide to the Companies under the FSA.

A. Under the proposed terms of the FSA, VNFC will provide various financial services to the Companies and other Verizon Telephone Operating Companies ("VTOCs") that are parties to the FSA. The services that VNFC will provide include the following: (1) funding consolidated daily short-term borrowing needs; (2) providing a vehicle for investing potential surplus funds; and (3) providing various financial management services. (Direct Testimony of Robert G. Deter, pp. 4-5)

Q. Please summarize the deficiencies that you have identified in the proposed FSA.

A. The Financial Services Agreement between the Companies and VNFC does not provide adequate protections to Verizon North and Verizon South. First, the FSA fails to stipulate that VNFC never charges interest rates in excess of those that the Companies could obtain in the open market. Second, surplus funds advanced by

the Companies to VNFC for investment are not required to be backed by revolving credit agreements, which would help ensure access to the funds when needed by the Companies. Finally, the FSA does not incorporate any eligibility requirements for the Companies' participation in the FSA.

Q. What eligibility requirements for the Companies' participation in the FSA do you recommend?

A. In order for the Companies to be eligible for participating in the FSA with VNFC, I recommend that VNFC and Verizon Communications be required to maintain their status as an "investment grade debt issuer" (as defined below). In the event that either company fails to meet this rating requirement, eligibility lapses and both Verizon North and Verizon South should be required to withdraw from the FSA.

Q. How should "investment grade debt issuer" be defined for the purposes of this proceeding?

A. For the purposes of this proceeding and its significance to the FSA, an "investment grade debt issuer" would maintain the minimum credit ratings described below from at least two of the following three major credit ratings agencies and no lower credit rating from the third credit rating agency: (1) a long-term credit rating of BBB- or above or a short-term credit rating of A-1 or above from Standard & Poor's ("S&P"); (2) a long-term credit rating of Baa3 or above or a short-term credit rating of P-1 or above from Moody's Investors Service ("Moody's"); and, (3) a long-term credit rating of BBB- or above or a short-term credit rating of F-1 or above from Fitch Ratings. In the event that the VNFC or Verizon Communications lose their status as an

investment grade debt issuer, the Companies' eligibility to participate in the FSA shall terminate.

Q. How do you propose to add this requirement to the FSA?

A. I propose to add the rating requirement to Section 7 – Termination. Specifically, Section 7(a) should be revised as follows:

- a. Termination by the Operating Company Following Notice. The Operating Company may unilaterally terminate this Agreement by giving 90 business days prior written notice of such termination to Network Funding, except as described in Section 7(c) of this Agreement.

Section 7(c) should be revised as follows:

- c. Immediate Termination. This Agreement shall be terminated immediately if Network Funding or Verizon Communications, Inc. is no longer an investment grade debt issuer. For purposes of this Agreement, an "investment grade debt issuer" shall mean companies that maintain the following minimum credit ratings from at least two of the following three major credit rating agencies and no lower credit rating from the third credit rating agency: (1) a long-term credit rating of BBB- or above or a short-term credit rating of A-1 or above from Standard & Poor's; (2) a long-term credit rating of Baa3 or above or a short-term credit rating of P-1 or above from Moody's Investors Service; and (3) a long-term credit rating of BBB- or above or a short-

85 term credit rating of F-1 or above from Fitch Ratings. In addition, this
86 Agreement shall be terminable immediately by either party hereto if all
87 of the common stock of Network Funding shall no longer be directly or
88 indirectly wholly owned by Verizon or its successor.

89 **Q. Does the FSA sufficiently protect the financial interests of the Companies**
90 **with respect to interest charges?**

91 A. No, the FSA does not sufficiently protect the Companies' financial interests. If the
92 interest rates remain as proposed in the FSA, the Companies may unfairly
93 subsidize affiliates because the interest rates are not required to be commensurate
94 with the risk of the Companies. Under the FSA, the Companies will pay interest on
95 the unpaid principal balance of all short-term loans from VNFC at a rate equal to
96 VNFC's cost of short-term funds. (Amended Joint Petition, Exhibit 1, p. 2) The
97 Companies should have the flexibility to obtain financing from outside sources if
98 they can obtain better interest rates.

99 **Q. How can the FSA be modified to eliminate the potential for interest rate**
100 **subsidies?**

101 A. To resolve the issues pertaining to interest rates, the language in the FSA must be
102 modified in the following manner. First, the FSA should specify that the interest rate
103 the Companies pay to VNFC, including issuing costs, never exceeds comparable
104 market interest rates. Second, the FSA should stipulate that interest earned on the
105 funds invested by the Companies is commensurate with what they could have
106 earned on investments of similar risk on the open market. Those modifications are

equitable safeguards that will protect the Companies from unfairly subsidizing affiliates. Accordingly, VNFC will be encouraged to maintain fair and reasonable interest rates given that the FSA will require interest rates to be equal to or lower than rates from outside market sources. In turn, the Companies gain the flexibility to obtain better interest rates when available in the market.

Q. How do you propose to modify the language in the FSA to stipulate the interest rate that the Companies would be required to pay to VNFC for all borrowings?

A. Section 2(a)(ii)(A) should be modified as follows:

(A) ~~Weighted Average Interest Rate. If Network Funding shall pay any interest, premiums, discounts, commissions or fees in connection with its short term borrowings during any money, the Short-Term Interest Rate shall be equal to the weighted average of all interest, premiums, discounts, commission and fees paid by Network Funding in connection with its short term borrowings each month. The Short-Term Interest Rate on borrowings made by the Operating Company from Network Funding shall be calculated at the lower of (i) the interest rate, including issuance costs, at which the Operating Company could have borrowed the funds pursuant to existing bank agreement(s) or commercial paper facility(ies) entered into between the Operating Company and an unaffiliated third party or parties, or (ii) Network Funding's actual interest cost, including issuance costs,~~

129 for the funds obtained or used to provide the funds borrowed by the
130 Operating Company.

131 Section 2(a)(ii)(B) would be eliminated in its entirety; thereby Section 2(a)(ii)(C)
132 would be renumbered as Section 2(a)(ii)(B).

133 **Q. Does the language in the Promissory Note that will evidence the loan from**
134 **VNFC to the Companies also need to be modified?**

135 A. Yes. The Promissory Note contains language regarding how interest charges will
136 be calculated on amounts loaned by VNFC to the Companies. That language
137 should be changed as follows:

138 Interest shall be charged on the unpaid principal balance hereof at a rate per
139 annum equal to the lower of (i) the interest rate, including issuance costs, at
140 which Borrower could have borrowed funds pursuant to existing bank
141 agreement(s) or commercial paper facility(ies) entered into between
142 Borrower and an unaffiliated third party or parties, or (ii) Lender's actual
143 interest cost, including issuance costs, for the funds obtained or used to
144 provide the funds lent to Borrower. ~~Lender's Cost of Funds (defined~~
145 ~~hereunder as the weighted average of all interest, premiums, discounts,~~
146 ~~commissions and fees paid by Lender in connection with its borrowings~~
147 ~~each month), such rate to change as Lender's Cost of Funds changes.~~

148 **Q. How do you propose to modify the language in the FSA to stipulate the**
149 **interest rate that VNFC would be required to pay to the Companies on all**
150 **short-term investments?**

A. Section 2(b)(ii) should be changed as follows:

(ii) Interest Rate and Receipts. Network Funding shall pay interest on the aggregate principal amounts of all Short-Term Investments by the Operating Company ~~at the Short-term Interest Rate~~, which shall be calculated at the higher of (i) the interest rate, including issuance costs, at which Network Funding could have borrowed the funds pursuant to existing bank credit agreement(s) or commercial paper facility(ies) entered into between Network Funding and an unaffiliated third party or parties, or (ii) the Operating Company's actual interest cost, including issuance costs, for the funds obtained or used to provide the funds to Network Funding.

The remainder of Section 2(b)(ii) would remain as proposed in the FSA.

Q. Should restrictions be placed on the amount of funds that the Companies may lend to VNFC for investment purposes?

A. Yes. Restrictions should be placed on the amount of funds that the Companies may lend to VNFC for investment purposes. Reasonable limitations on the amount of such funds would ensure that the Companies' funds are available for withdrawal when needed. Although the FSA specifies that the Companies would have the right to demand repayment of all or any part of the principal amount and accrued interest on any short-term investment outstanding on any business day without penalty; the FSA fails to incorporate safeguards to ensure that VNFC would have funds available to meet such repayment requests. Surplus funds lent to VNFC from all

participants for investment should not be permitted to exceed the unused balance of funds actually available to VNFC under revolving credit agreements at any time plus the amount VNFC invests in the government securities described in Section 3(c) of the proposed FSA. Additionally, the financial institutions with which VNFC maintains a revolving credit agreement should have at least two of the following credit ratings: A- by S&P; A3 by Moody's; or A- by Fitch Ratings, at the time the institutions enter into said agreement with VNFC. This minimum credit rating would provide assurance that the financial institutions have sufficient liquidity to honor their commitments.

Q. How do you propose to modify the FSA to restrict the amount of surplus funds that can be lent to VNFC?

A. Section 2(b)(i) should be modified in the following manner:

- (i) Short-Term Investments. The Operating Company shall be permitted to lend funds on a day-to-day basis to Network Funding on any business day ("Short-Term Investments"). The aggregate amount of funds lent to Network Funding by Eligible Verizon Affiliates shall not exceed the unused balance of funds actually available to Network Funding under revolving credit agreements at any time plus the amount Network Funding invests in the securities described in Section 3(c) of this Agreement. The financial institutions with which Network Funding maintains a revolving credit agreement shall have at least two of the following credit ratings: A- from Standard & Poor's;

A3 from Moody's Investors Service; or A- from Fitch Ratings, at the
time the institutions enter into said agreement with Network Funding.

**Q. Are the limitations on the types of investments that VNFC is allowed to
invest the surplus funds of the Companies sufficient?**

A. If the Commission restricts the amount of surplus funds the Companies may invest with VNFC in the manner described above, then the limitations on the types of investments available to VNFC described in Section 3 of the Agreement are sufficient. Alternatively, if the Commission does not elect to restrict the amount of surplus funds the Companies may invest with VNFC, then the Commission should prohibit Verizon North and Verizon South from loaning funds to VNFC in the event Verizon North or Verizon South loses its status as an "investment grade debt issuer," as previously defined. Further, the Commission should prohibit VNFC from investing in debt securities of affiliates with maturities in excess of 364 days or with affiliates that are not "investment grade debt issuers." The first restriction would ensure that neither of the Companies would be providing funds to VNFC when the Companies face serious financial difficulties given that the funds lent to VNFC would not be secured. The second restriction would better match the term to maturity of VNFC's loans to affiliates with the term to maturity of the surplus funds the Companies would invest with VNFC, since both would be restricted to the short-term. The third restriction would increase the safety of the Companies' surplus funds invested with VNFC by only allowing loans to affiliates with a better ability to repay the loans. Together, those proposed restrictions would reduce the probability

that VNFC would be unable to repay the Companies' surplus funds on demand as the Agreement would require. However, this alternative is inferior to limiting the amount of funds to the unused balance of funds actually available to VNFC under revolving credit agreements because even investment grade debt issuers may experience liquidity problems from time to time.

Q. How do you propose to amend the FSA to incorporate these additional limitations on types of investments if the Commission elects not to restrict the amount of surplus funds the Companies may invest with VNFC?

A. If the Commission prefers this alternative, Section 2(b)(i) should be modified in the following manner:

(i) Short-Term Investments. The Operating Company shall be permitted to lend funds on a day-to-day basis to Network Funding on any business day unless the Operating Company loses its status as an "investment grade debt issuer" as defined in Section 7(c) of this Agreement ("Short-Term Investments").

In addition, Section 3(a) should be revised as follows:

a. Affiliate Debt Securities. Debt securities issued with a term to maturity of 364 days or fewer by Eligible Verizon Affiliates, including the Operating Company, that are "investment grade debt issuers" as defined in Section 7(c) of this Agreement;

Q. What information do you propose to require the Companies to file in reports to the Commission?

- 239 A. The Companies should maintain supporting documentation for all deposits,
240 borrowings, interest income, and interest expense relating to transactions with
241 VNFC. Such written documentation shall include the following:
- 242 1) Documentation of borrowings from VNFC, including the date of the borrowing,
243 the amount of the borrowing, the maturity date of the borrowing and the renewal
244 dates (if any), the interest rate of the borrowing, and any security in support of
245 borrowings from VNFC.
 - 246 2) Documentation of individual deposits with VNFC for short-term investment,
247 including the date of the deposit, the amount of the deposit, the maturity date of
248 the deposit and the renewal dates (if any), the interest earning rate of the
249 deposit, and the security provided by VNFC for the repayment of any deposits
250 from the Companies.
 - 251 3) Daily balances of all borrowings from and deposits with VNFC for each
252 individual borrowing or deposit. Cash borrowings and deposits may not be
253 netted.
 - 254 4) Detailed statements documenting the unused amount of VNFC's revolving
255 credit agreement, the balance of funds invested in each of the three types of
256 investments available to VNFC as described in Section 3 of the Agreement,
257 and the total amount the Operating Companies loaned to VNFC.
- 258 The Companies should be required to file a report with the Commission to present
259 the required information on a quarterly basis. The first report should be filed within
260 thirty (30) days after the end of the applicable calendar quarter (i.e., the three-month
261 period ending March 31, June 30, September 30, or December 31) in which the

order in this proceeding is entered. Thereafter, reports should be filed covering the transactions during each successive three-month period, each report to be filed within thirty (30) days after the end of each three-month period.

VNFC should also file quarterly unaudited financial statements and annual audited financial statements. The quarterly unaudited financial statements of VNFC shall be filed within forty-five (45) days of the end of the applicable calendar quarter. The annual audited financial statements of VNFC shall be filed within ninety (90) days after the end of VNFC's fiscal year.

All reports should be signed and verified under oath by an executive officer having knowledge of the facts and filed with the Office of the Chief Clerk of the Commission in duplicate with a copy provided to the Manager of the Finance Department. Each report should state on its face that it is filed pursuant to Docket No. 02-0396.

Q. Should the Companies be required to obtain Commission approval to add participants to the FSA?

A. No, the Companies should be allowed to add affiliates to the FSA, with the exception of Verizon Communications, without Commission approval. Verizon Communications should be prohibited from borrowing from VNFC. This provision would prevent Verizon Communications from ordering the Companies to lend Verizon Communications funds when it is not in the best interests of the Companies to do so. However, the Companies should be required to file a report with the Commission of all parties that can participate in affiliate transactions with the Companies. The report should contain a list of all companies involved, indicating

which companies have been added and the date those companies entered into the FSA. An update of the report should be due within 10 days of a company being added to the FSA.

Q. Are you aware of any problems that the Companies have had under the current agreement with GTE Funding Inc.?

A. No.

Q. Is the FSA proposed in this proceeding similar to the current FSA with GTE Funding Inc.?

A. Yes, with the exception of two sections. The current agreement authorized in Docket No. 96-0334 contains a provision that requires GTE Funding to maintain all corporate formalities generally associated with separate and distinct corporate entities. The current FSA also requires GTE Funding to prepare quarterly unaudited financial statements and annual audited financial statements. I recommend that VNFC be required to file the financial statements as part of the reporting requirement.

Q. Why is modifying the proposed FSA to include these additional provisions necessary?

A. Although no problems have yet surfaced in the operation of the GTE Funding FSA, recent events in the telecommunications and energy industries have shown how quickly a company and its affiliates can experience a liquidity crisis. Adding these provisions to the FSA along with the reporting requirement will help protect the funds

305 of the Companies and ensure that the Companies are not subsidizing affiliate
306 companies.

307 **Q. Should the Companies continue participating in the current agreement with**
308 **GTE Funding Inc. if the proposed agreement with VNFC is approved and**
309 **executed?**

310 A. No. The current agreement with GTE Funding Inc. should be cancelled upon
311 execution of the proposed FSA with VNFC.

312 **Q. Should the Companies provide any further information in this proceeding?**

313 A. Yes. The FSA permits companies that provide support services to the VTOCs to
314 borrow and invest with VNFC. The Companies should specify which companies
315 provide such support services to the VTOCs and are parties to the agreement.

316 **Q. Does this question conclude your direct testimony?**

317 A. Yes.